Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of

The National Exchange Carrier Association Inc.	)	
Proposed Revision of Part 69 of the	)	
Commission's Rules to Allow for Incentive	)	RM 8389
Settlement Options for NECA Pool Companies	)	

Supplemental Comments

National Exchange Carrier Association, Inc.
100 South Jefferson Road
Whippany, New Jersey

May 15, 1995

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Motion to Accept Supplemental Comments

The National Exchange Carrier Association, Inc. (NECA) requests the Common Carrier Bureau of the Federal Communications Commission to authorize and accept the filing of the accompanying Supplemental Comments to NECA's Petition for Rulemaking in the above captioned matter.[1] This request is being made pursuant to Section 1.405(c) of the Commission's rules.[2]

NECA believes that the filing of Supplemental Comments in this proceeding is warranted because it has modified one of its proposals to enhance customer benefits through an optional pool incentive plan. This modification not only reflects recent Commission intent and action in the price cap arena but also addresses the concerns previously raised by AT&T and MCI in this proceeding. By replacing the Pool Profit Sharing Option Plan with the Customer Dividend Option Plan, NECA believes it is clearing the way to the Commission's adoption of a Notice of Proposed Rulemaking in this proceeding.

The filing of these Supplemental Comments should assist both the Commission and the

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[1] Proposed Revision of Part 69 of the Commission's Rules to Allow for Incentive Settlement Options for NECA Pool Companies, RM 8389, NECA Petition for Rulemaking, filed Nov. 5, 1993.

[2] 47 C.F.R. § 1.405(c).

public in analyzing and moving forward on optional incentive plans for NECA members. To facilitate this review and in accordance with Commission rules, NECA is serving copies of these Supplemental Comments to all parties to this proceeding.

For the reasons described above, NECA respectfully requests the Commission to accept the attached supplemental comments in order to provide a full record regarding NECA's Petition for Rulemaking - RM 8389.

Respectfully submitted,

NATIONAL EXCHANGE CARRIER
ASSOCIATION, INC.

Joanne S Bochis

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May 15, 1995

CERTIFICATE OF SERVICE

I hereby certify that copies of the foregoing Motion to Accept Supplemental Comments were served this 15th day of May, 1995, by mailing copies thereof by United States Mail, first class postage paid, to the people listed.

By ______________________
Lisa L. Leibow

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May 15, 1995

TABLE OF CONTENTS

SUMMARY

In 1993, the National Exchange Carrier Association, Inc. filed a Petition for Rulemaking proposing rule revisions to allow it to offer incentive settlement options within the NECA pools. To ensure that customers realize up-front benefits from NECA's incentive options, NECA has replaced, as shown in these Supplemental Comments, the Profit Sharing Incentive Option with the Customer Dividend Option.

The Customer Dividend Option is like the Profit Sharing Incentive Option in a number of ways: it would allow a cost-company in NECA's pools to elect incentive regulation for either traffic sensitive services only or for both common line and traffic sensitive services; it would require a minimum commitment of two, two-year incentive periods; and under it, EC-specific settlement rates would be based on historical revenue requirements and demand. The difference that makes the Customer Dividend Option attractive to customers lies in settlement rate calculations. Under the Customer Dividend Option, settlement rate calculations would have a customer dividend factor equal to 0.65%.

NECA believes that a sound record has been established in this proceeding for the Commission to combine this newly proposed Customer Dividend Option with prior proposals for the Small Company Incentive Option, pricing flexibility, streamlined filing, and pro forma rule changes into a Notice of Proposed Rulemaking. Ultimate adoption of incentive options for NECA pool members will allow NECA small company members and their customers to enjoy the benefits and challenges of incentive regulation that the Commission has previously adopted for those companies that are no longer NECA pool members.

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Supplemental Comments

I. Introduction

In 1993, the National Exchange Carrier Association, Inc. (NECA) [1] filed a Petition for Rulemaking proposing rule revisions to allow it to offer incentive settlement options within the NECA pools.[2] To ensure that customers realize up-front benefits from NECA's incentive options and to address some commenters' concerns about the Petition,[3] NECA now files Supplemental Comments which revise its proposal.

II. Background

In the Commission's Regulatory Reform Order,[4] the Commission encouraged NECA to introduce incentive options into the pooling process. Recently, the Commission completed an

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[1] NECA is a not-for-profit, membership association, serving over 1400 local exchange carrier (EC) study areas. NECA members include all local exchange carriers in the United States, Puerto Rico and the U. S. Virgin Islands.

[2] Proposed Revision of Part 69 of the Commission's Rules to Allow for Incentive Settlement Options for NECA Pool Companies, RM 8389, NECA Petition for Rulemaking, filed Nov. 5, 1993 (Petition).

[3] See AT&T Comments and MCI Comments on Petition, filed Dec. 16, 1993.

[4] Regulatory Reform for Local Exchange Carriers Subject to Rate of Return Regulation, CC Docket No. 92-134, Report and Order, 8 FCC Rcd 4545 (1993) (Regulatory Reform Order).

extensive review of its Exchange Carrier (EC) Price Cap plan, and modified rules on incentive regulation.[5] NECA reflects the Commission's changed view of the customer sharing component in incentive options by replacing the "Pool Profit Sharing Incentive Option" in the Petition with the new "Customer Dividend Option" described below.

This new Option removes profit sharing and adds an explicit customer dividend which leads to reductions in NECA tariff rates through lower settlement rates for companies electing the option. This change furthers the Commission's tentative holdings in the Price Cap Review Order that the sharing and low-end adjustment mechanisms should be eliminated as part of a permanent price cap plan for exchange carriers.[6]

With the introduction of the Customer Dividend Option, NECA believes it has adapted its incentive options to conform to the Commission's Price Cap Review Order and addressed the major concern raised by AT&T and MCI in comments on the Petition. These commenters were not convinced that ratepayers would benefit from NECA's Pool Profit Sharing Incentive Option. NECA's revised options do give EC customers immediate and guaranteed benefits by lowering access costs for NECA's pools.

Most commenters on the Petition agreed that NECA's incentive options would help to fulfill the Commission's goal to provide regulatory reform to small and mid-sized exchange carriers. Commenters strongly supported NECA's proposed settlement options.[7] They noted that

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[5] Price Cap Performance Review for Local Exchange Carriers, First Report and Order, 60 Fed. Reg. 19526-02 (Apr. 19, 1995), FCC 95-132 (rel. Apr. 7, 1995) (Price Cap Review Order).

[6] Id. at ¶ 184.

[7] See, e.g., Comments on the Petition by United States Telephone Association (USTA) at
(continued...)

the settlement options are a good response to the Commission's request for incentive options for pooled services,[8] and support the Commission's effort to provide regulatory reform to small and mid-sized exchange carriers.[9] In addition, parties supported NECA's proposed extension of regulatory incentive benefits to ECs within the NECA pools,[10] and endorsed NECA's proposal because it would afford NECA pool members the opportunity to adopt an incentive regulation plan, while maintaining the efficiencies inherent in pool membership.[11]

III. Description of NECA's Proposed Pool Customer Dividend Option

A. Pool Customer Dividend Option Features

NECA designed its originally proposed Profit Sharing Incentive Option to look and operate like the Commission's Optional Incentive Regulation (OIR) plan.[12] The differences

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[7](...continued)
1, Century Telephone Enterprises, Inc. (Century) at 1, John Staurulakis, Inc. (JSI) at 2, Puerto Rico Telephone Company (PRTC) at 1, Organization for the Protection and Advancement of Small Telephone Companies (OPASTCO) at 4, Cathey, Hutton & Associates (CHA) at 2, Union Telephone Company (Union) at 2, PTI Communications (PTIC) at 2, and National Telephone Cooperative Association (NTCA) at 1.

[8] See, e.g., PTIC at 2.

[9] USTA at 1.

[10] See, e.g., USTA at 2, Century at 1, JSI at 2, and NTCA at 1 and 2.

[11] See, e.g., OPASTCO at 3, CHA at 2, NTCA at 2, and Union at 1.

[12] In its Regulatory Reform Order, the Commission, *inter alia,* adopted tariff rules to implement regulatory reform for small and mid-size, rate of return ECs. The optional plan permits carriers to establish rates based on their historical costs. Under this plan, during the two-year period before rates are revised, carriers are permitted to retain higher earnings than those that utilize prospective cost estimates in their ratemaking processes. The plan also permits pricing flexibility and streamlined treatment for the introduction of new services. See Regulatory Reform Order at 4546.

between the two plans were mainly adaptations of OIR needed to make this plan work in a pooling environment. NECA proposes continued use of some of the same features in the new Customer Dividend Option. Under the new option, like the old one, a cost-company in NECA's pools can elect incentive regulation for either traffic sensitive services only or for both common line and traffic sensitive services. An incentive period will last two years, but with a minimum commitment period of four years, i.e., two, two-year incentive periods are required.

As with the Profit Sharing Incentive Option, the Customer Dividend Option uses formulas to calculate EC-specific settlement rates. The settlement rate determines the amount of funds an EC receives from the pool per unit of traffic. An incentive company will charge its customers NECA's uniform tariff rates. Settlement rates within the pool simulate tariff rates for incentive companies outside the pool.

Both options use historical revenue requirements and demand to set settlement rates. NECA would reset these settlement rates at the end of a two-year incentive period to the authorized rate of return. The settlement rates would reflect exogenous rules changes as defined by Commission rules.

In the Customer Dividend Option, the calculations that set the settlement rates would have a customer dividend factor equal to 0.65%. By itself, this factor would lower a company's settlement rates by 0.65% per year. This factor was not part of the calculations under the previously proposed Profit Sharing Incentive Option. Instead, under the Profit Sharing Option, there was a cash payout to customers if the profits of incentive companies exceeded 150 basis points above the authorized rate of return.

The following example illustrates how the customer dividend impacts the settlement rate calculation for Traffic Sensitive Switched settlement rates. The formula proposed for this settlement rate is switched revenue requirement divided by minutes of use.[13] The example assumes a four-year plan beginning July 1, 1995.[14]

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[13] Common Line services will have two formulas, one per line and one per minute. The per line formula will follow End User Subscriber Line Charge rules described in 69.104. The per minute formula is the one described in 61.50(k). The special access formula is a retention ratio. This ratio is the amount retained per dollar of tariff revenue. The CCL, TS switched and special formulas decline by the customer dividend each year of the two-year incentive settlement period.

[14] In the illustrative example, Line 1 shows the proposed customer dividend level of 0.65%. Lines 2 and 3 provide hypothetical base year (1994) revenue requirement and minutes of use respectively. Line 4 shows what the settlement rate would be for the initial incentive period if the customer dividend were not applied (Line 2 at the authorized rate of return divided by Line 3). In this example the settlement rate at the authorized rate of return would be 4 cents. Line 5 shows the calculation result of applying the customer dividend for the first year of the first two-year incentive settlement period. This $0.000260 per minute of use amount is the product of the settlement rate before the customer dividend and the customer dividend factor of 0.65%. As shown in Line 6, the settlement rate for the first year of the first two-year incentive period is calculated by subtracting the customer dividend amount from the settlement rate before the customer dividend. For the second year of the first two-year incentive settlement period, the customer dividend amount is the product of the settlement rate for the first year ($0.039740) and 0.65%, the ongoing customer dividend factor. In this example, the customer dividend amount for the second year of the first two-year incentive settlement period is an additional 0.000258 per minute of use to be subtracted from the prior year settlement rates.

For the second two-year incentive settlement period new base period data are used. In the illustrative example, the values of $940 and 24,000 have been assumed for the July 1995-1997 revenue requirement (Line 9) and Minutes of use respectively (Line 10). Any change in authorized rate of return is also incorporated into the revenue requirement. Again, dividing the revenue requirement by the minutes of use provides the settlement rate before the customer dividend at the authorized rate of return (Line 11). Here, this amount is $0.039167. Further, multiplying the settlement rate by 0.65% gives us the customer dividend amount for the first year of the second two-year incentive settlement period (Line 12), or $0.000225 per minute of use. The customer dividend amount is then subtracted from the settlement rate and the example proceeds as in the first two-year incentive settlement period above.

CUSTOMER DIVIDEND OPTION

TRAFFIC SENSITIVE SWITCHED ACCESS INCENTIVE SETTLEMENT RATES

ILLUSTRATIVE EXAMPLE

1. Customer Dividend Percent	0.65%
FIRST 2-YEAR PERIOD	
2. 1994 Revenue Requirement	$400
3. 1994 MOU	10,000
4. Rate before Customer Dividend	$0.040000 (Line 2/ Line 3)
5. Customer Dividend Amount	$0.000260 per MOU (Line 1 X Line 4)
6. Settlement Rate 95/96	$0.039740 (Line 4 - Line 5)
7. Customer Dividend Amount	$0.000258 per MOU (Line 6 X Line 1)
8. Settlement Rate 96/97	$0.039482 (Line 6 - Line 7)
SECOND 2-YEAR PERIOD	
9. 7/95 thru 6/97 Revenue Requirement	$940
10. 7/95 thru 6/97 MOU	24,000
11. Rate Before Customer Dividend	$0.039167 (Line 9 / Line 10)
12. Customer Dividend Amount	$0.000255 per MOU (Line 1 X Line 11)
13. Settlement Rate 97/98	$0.038912 (Line 11 - Line 12)
14. Customer Dividend Amount	$0.000253 per MOU (Line 13 X Line 1)
15. Settlement Rate 98/99	$0.038659 (Line 13 - Line 14)

B. Pool Customer Dividend Option Justification

In the Price Cap Review Order, the Commission reasoned that profit sharing did not produce the desired incentives.[15] In addition, AT&T and MCI wanted guarantees that NECA's incentive options would lower their access costs.[16] In response, NECA is replacing the Profit Sharing Incentive Option with the Customer Dividend Option.

NECA derived the 0.65% customer dividend[17] by taking half of the 1.3% difference between the 4.0% productivity factor for the basic EC price cap offering with profit sharing and the 5.3% productivity factor for the option without profit sharing.[18] NECA selected the mid-point recognizing that pool members have fewer opportunities to exploit economies of scale and scope than larger companies.

The Commission has already recognized this difference in its small company plans described in Sections 61.50 and 61.39 of the Commission's rules.[19] These plans freeze rates for two-year periods. By freezing rates, these Commission options have implicitly established for smaller companies a productivity rate equal to the rate of inflation. In other words, a small EC must absorb a general rise in prices without having the ability to raise its own rates.

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[15] See Price Cap Review Order at ¶¶ 187-191.

[16] See AT&T Comments on the Petition at 4-5 and MCI Comments on the Petition at 7-8, filed Dec. 16, 1993.

[17] See page 4, supra.

[18] Price Cap Review Order at ¶ 199-200.

[19] 47 C.F.R. §§ 61.50 and 61.39.

For the past three years, the average rate of inflation equaled 3.0%.[20] Therefore, the productivity expected from companies on these incentive options equaled 3.0%, which is one percent lower than the 4.0% productivity target for the price cap option that includes profit sharing. Since smaller ECs have fewer opportunities to improve productivity through economies of scale and scope, it follows that they should also have a lower dividend rate.

With the customer dividend of 0.65%, and assuming the inflation continues to equal 3.0%, the overall productivity factor facing exchange carriers that elect the Customer Dividend Option equals 3.65%. This challenging hurdle will result in real price reductions in constant dollars for access customers, while the two-year retargeting of rates provides a proper risk/reward balance for both exchange carriers and their customers. This feature also serves to limit the profit potential associated with these options.

IV. NECA's Pool Small Company Option Will Allow the Smallest Companies to Participate in Incentive Regulation.

Subset III companies[21] would be eligible for NECA's Pool Small Company Incentive Option, which continues to be based on Section 61.39 of the Commission's rules.[22] Under this

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[20] This average inflation rate was calculated by averaging the Gross Domestic Product Fixed Weight Price Index for the years 1992, 1993, and 1994, as reported by the Department of Commerce's Bureau of Economic Analysis.

[21] Section 69.602 of the Commission's rules, 47 C.F.R. § 69.602, divides NECA's membership into three subsets. The third subset consists of all telephone companies with annual operating revenues of forty million dollars or less.

[22] 47 C.F.R. § 61.39. Mirroring this rule, NECA would limit this option to Subset III companies with less than 50,000 access lines.

option settlement rates are frozen for two years.[23] This means that the productivity factor equals the rate of inflation. Companies in NECA's pools with less than 50,000 lines have even less opportunity to exploit economies of scale and scope than the larger ones. Guaranteeing cost reductions equal to the rate of inflation is a strong efficiency commitment for these companies. The Pool Small Company Incentive Option would also allow study areas to continue to benefit from administrative cost savings that come as part of being a pool member, and in turn, pass those savings on to customers.

In addition to its optional pool incentive plan proposals, NECA continues to seek streamlined new service introduction and pricing flexibility.[24] These features would provide enhancements to NECA's current tariff procedures for all pool participants. Pool neutrality would be enhanced by adoption of parallel regulation. Finally, NECA also proposes pool settlement rule revisions that reflect the methodology actually used for pooling.[25]

Attachment 1 contains NECA's proposed rules to implement Pool Incentive Options. NECA urges the Commission to include these rule changes in a Notice of Proposed Rulemaking.

V. The Pool Processes That Would Be Used for Optional Incentive Settlements are Compatible with Existing Pooling Procedures.

For tariff rate setting and pooling, NECA has tailored its proposed incentive plans to look and operate like average schedules.[26] NECA was able to do this because average schedules and

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[23] See Petition at 11-12.

[24] See Regulatory Reform Order at 4550-51. See also Petition at 14-15.

[25] See Petition at 12-14.

[26] See 47 C.F.R. § 69.606.

the proposed optional incentive plans contain close similarities in concept and design. Both the average schedules and incentive plans use formulas to calculate settlement rates. For tariff rate setting, NECA would multiply these settlement rates by their respective forecasted demand levels to forecast pool settlements. Both types of forecasted settlements would be added to cost company revenue requirements to forecast a pool's total revenue requirement.[27] With optional incentive plans operational, NECA would also sum average schedule, incentive plan, and cost company demand forecasts to forecast a pool's forecasted demand levels. From these revenue requirement and demand aggregates, NECA would calculate its test period tariff rates.

The only differences between the average schedule and incentive plans lie in the formulas used to derive settlement rates and the data inputted into the formulas. Based on a study area's loop count, traffic volumes, and other relevant cost-drivers, an average schedule company simply sees where it falls on the schedule in a given month to determine its settlement rate. The schedules, themselves, are estimated statistically using cost and demand data for companies of varying size. There are ten average schedule formulas used to determine settlement levels.[28]

Computing settlement rates for incentive companies is even more simple than doing so for average schedule companies. NECA would use four settlement formulas, two for common line, one for traffic sensitive switched, and one for special access. The common line formulas are

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[27] Incentive company revenue requirements for each access element would be clearly identified in the annual filings. Attachment 2 contains a proposed, revised Tariff Review Plan exhibit to reflect the changes which would occur as a result of implementation of NECA's optional pool incentive plans as proposed herein. The revision adds line 263 to include incentive company settlements.

[28] See 1995 NECA Modification of Average Schedules, filed Dec. 30, 1994 (Average Schedule Filing).

identical to the one used by the OIR plan and Section 61.39 of the Commission's Rules.[29] The traffic sensitive switched formula is traffic sensitive switched revenue requirement divided by switched access minutes of use. The special access settlement formula is a retention ratio -- the same formula used by average schedules. NECA would use a study areas' own cost and demand data from an historical base period to calculate the study area-specific settlement rates.[30]

As with average schedules, incentive plan settlement rates will adjust with pool realized earnings. This adjustment recognizes that a pool study area's earnings under the incentive plans should vary if NECA tariff rate levels do not earn the exact authorized rate of return due to variations in cost and demand levels. An incentive company will therefore share in the risks associated with these tariff inaccuracies the same as do all other pool members. The incentive companies would have a settlement adjustment that would decrease or increase their monthly settlements based on whether the achieved pool earnings, for all pool companies (cost, average schedule, and incentive), are below or above the authorized rate of return. This mechanism is similar to adjustments made today in NECA's pools to maintain an equivalent rate of return between cost and average schedule companies.

For example, for the traffic sensitive pool, the proposed factor for adjusting the average schedule rate of return for small company participants is:

Traffic Sensitive Factor = .684427 + (2.805093 x Rate of Return)[31]

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[29] 47 C.F.R. § 61.39(4).

[30] NECA's Pool Procedures incorporate cost study and demand true-ups to assure accuracy of settlement rates. See Attachment 3.

[31] Average Schedule Filing.

While the same traffic sensitive formula is used for all average schedule companies, each cost company incentive option participant would have a unique rate of return factor based on its cost study.

The purpose of the rate adjustment factor is to ensure equal treatment to all pooling companies. Neither traditional cost nor average schedule companies would be penalized by the proposed settlement options. In fact, the new options are likely to lead to greater earnings stability. Incentive companies would receive a fixed settlement rate per minute of use. This would reduce the cost variability from NECA filing projections.[32] Draft Pool Administration Procedures for NECA optional incentive settlements which explain these operations more fully are attached.[33]

VI. Conclusion

NECA's Supplemental Comments have improved its original proposal. The Customer Dividend Option has substituted immediate customer benefits for the prior profit sharing mechanics. These changes meet the Commission's goals for incentive plans as well as ameliorate the concerns expressed by AT&T and MCI in the initial pleading cycle. NECA also believes that a sound record has been established in this proceeding for the Commission to combine the

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[32] To forecast overall tariff settlement levels, NECA would still maintain current practices of projecting demand for these companies.

[33] See Attachment 3. NECA's Pool Administration Procedures are internal documents updated as needed. The Draft Pool Administration Procedures for NECA Incentive Settlement Options included in this filing are for explanatory purposes only.

Customer Dividend Option with prior proposals for the Small Company Incentive Option, pricing flexibility, streamlined filing, and pro forma rule changes into a Notice of Proposed Rulemaking.

Respectfully submitted,

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May 15, 1995

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ATTACHMENT 1

PROPOSED RULES